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OCTOBER TERM, 1971

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FEDERAL POWER COMMISSION, PETITIONER

v.

MOBIL OIL CORPORATION, ET AL.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

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The Solicitor General, on behalf of the Federal Power Commission, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the District of Columbia Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (Mobil App. 15–40)[1] is not yet reported. The opinion of the Federal Power Commission (Mobil App. 41–80) is reported at 42 FPC 164. The opinion of the hearing examiner (Mobil App. 81–107) is reported at 42 FPC 187.

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[1] "Mobil App." references are to the appendices to Mobil Oil Corporation's petition for a writ of certiorari (No. 71-1169) from the judgment of the court of appeals in this case.

JURISDICTION

The judgment of the court of appeals (Mobil App. 11–13) was entered on December 17, 1971. On March 13, 1972, the Chief Justice extended the time for filing a petition for a writ of certiorari to April 15, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

QUESTION PRESENTED

Whether the Federal Power Commission has authority under the National Gas Act, 15 U.S.C. 717, *et seq.*, to regulate royalty payments to landowners, or their successors or assigns, on natural gas sold for resale in interstate commerce.

STATUTE INVOLVED

Sections 1(b) and 2(6) of the Natural Gas Act, 15 U.S.C. 717(b) and 717a(6), provide:

Section 1(b):

> The provisions of this Act shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural-gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas.

Section 2(6):

> "Natural-gas company" means a person engaged in the transportation of natural gas in interstate commerce, or the sale in interstate commerce of such gas for resale.

STATEMENT

This case involves the Federal Power Commission's determination that it has jurisdiction under the Natural Gas Act, 15 U.S.C. 717, *et seq.*, to regulate royalty payments to landowners, or their successors or assigns, for their interests in natural gas sold for resale in interstate commerce. On review of the Commission's order, the court of appeals reversed. In addition to the instant petition, four other parties have petitioned this Court for review of the decision below.[2]

This controversy came to the Commission as a result of an action brought by certain royalty owners in a federal district court seeking royalty payments on the sale of natural gas in interstate commerce, under the terms of certain mineral leases granted to a producer of oil and natural gas.[3] The royalty owners contended

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[2] *Mobil Oil Corporation* v. *Carl E. Matzen, et al.*, No. 71-1169; *Amoco Production Company* v. *Leland C. Wuchter, et al.*, No. 71-1179; *Cities Service Oil Company* v. *Carl E. Matzen, et al.*, No. 71-1188; and *Shell Oil Company* v. *Carl E. Matzen, et al.*, No. 71-1191. We do not intend to file any responses to these petitions.

[3] In an oil and gas lease, the lessor's right to royalties is usually expressed in terms of a fraction of the proceeds from, or the market value of, the gas produced (Mobil App. 92). While the most common royalty fraction is one-eighth, in some instances it is larger (Mobil App. 91). Infrequently, the royalty

that, under the leases, their royalty payments should be calculated on the basis of the unregulated wellhead market price of natural gas, rather than on the basis of the rates filed by the producer with the Commission and collected from the interstate pipeline to which the gas was sold. The district court ruled in favor of the royalty owners, holding that the Commission has no jurisdiction over royalties; the court also held that under the leases royalties were to be paid on the basis of wellhead market price even if that value exceeded the just and reasonable rate determined by the Commission for interstate sales of natural gas from the leaseholds in question. *Denman* v. *J. M. Huber Corp.*, 251 F. Supp. 746 (N.D. Tex). On appeal, the Fifth Circuit agreed that the leases provided for the payment of royalties on the basis of market price, but ruled that the Commission had primary jurisdiction to decide whether it has jurisdiction over royalty owners and their interests in interstate sales of natural gas. 367 F.2d 104.

Following the Fifth Circuit's decision, the royalty owners in *Huber* petitioned the Commission for an order disclaiming jurisdiction over royalties. The producer in that case, J. M. Huber Corporation, opposed

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owner reserves the right to take natural gas in kind (*ibid.*). Under the lease, the royalty owner receives payment for his interest free of any of the costs of production, except taxes, and is protected by certain implied covenants with respect to the development of the lease and the marketing of the product (Mobil App. 92). The royalty owner is also permitted a depletion allowance under the federal income tax laws (R. 36). "R." references are to the printed appendix filed with the court below.

the petition (Mobil App. 85–86). Subsequently, Mobil Oil Corporation, another producer, filed a complaint (R. 312–323) seeking a Commission ruling that its royalty obligations are governed by its effective rates on file with the Commission. Mobil's complaint was filed in response to 283 individual suits and one class action brought against it in state courts in Kansas by royalty owners claiming royalties based on rates in excess of Mobil's effective rates on file with the Commission. Similar complaints were later filed with the Commission by Western Natural Gas Company (Mobil App. 86–87)[4] and Amoco Production Company (Mobil App. 87), who had also been sued in state courts by royalty owners.[5]

The Commission consolidated all the proceedings and set for hearing the question of its jurisdiction over payments made to royalty owners with respect to natural gas sold in interstate commerce and the question of how such jurisdiction, if it exists, should be implemented (R. 386–391).

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[4] The Commission, by order issued February 23, 1972, in Docket No. R167–310, approved a settlement between Western and its royalty owners. On March 2, 1972, the court of appeals permitted Western to withdraw its petition for review of the Commission's opinion in this case.

[5] The claims of some of these royalty owners are made under leases containing "market price" or "market value" royalty provisions, while others make the same contentions under leases containing "proceeds" royalty provisions (Mobil App. 92–93). These court proceedings have been stayed or otherwise held in abeyance, pending a final determination on the Commission's jurisdiction.

In its opinion (Mobil App. 41–80) the Commission affirmed the examiner's decision (Mobil App. 81–107) that royalty owners are engaged in sales of natural gas in interstate commerce and that, with respect to such sales, the royalty provisions in mineral leases are thus subject to the Commission's jurisdiction. In distinguishing the bonus[6] and the delay rental[7] provisions in such leases from the royalty provisions, the Commission explained (Mobil App. 53):

> The basic fact here is the effective retention by the royalty holders of a percentage interest in the gas sold in interstate commerce. While that portion of the royalty contract on which the royalty owners focus, which results in payments prior to the production or discovery of natural gas or payments unconnected with the production of gas, may well be nonjurisdictional under the decision in [*Federal Power Commission* v. *Panhandle Eastern Pipe Line Co.*, 337 U.S. 498], the remaining portion of the arrangement, which results in payment to the royalty holder based on the production of natural gas for sale in interstate commerce, seems to us plainly to be jurisdictional. * * *

The Commission reasoned that since a royalty owner in executing a lease contracts to retain an "economic interest" in any subsequent interstate sales, he joins

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[6] A bonus is a cash payment by a producer to a lessor on the signing of a mineral lease, and has no direct relation to the ultimate quantity of natural gas actually produced from the leasehold.

[7] A delay rental is a payment made for the privilege of deferring drilling operations or production.

with other interest holders in such sales and thus is a seller of natural gas in interstate commerce. Accordingly, the Commission found that royalties constitute payment to royalty owners for their interest in the interstate sales (Mobil App. 54).[5] Since the sales are within the Commission's jurisdiction under Section 1(b) of the Natural Gas Act, 15 U.S.C. 717(b), the royalty owners are "natural gas companies" under Section 2(6) of the Act, 15 U.S.C. 717a(6), subject to the Commission's jurisdiction.

Having resolved the jurisdictional issue, the Commission further held (Mobil App. 56–57) that royalty rates for interstate sales are to be governed by either the rate provided for in the lease or the just and reasonable rate as determined by the Commission, whichever is lower. In addition, the Commission ruled that royalty owners are covered by the rate filings of producers and are not required to file separately with the Commission, even though their authorized royalties might be based on a rate higher than that which the producers, under their filings, are authorized to collect from the interstate pipelines to whom the gas is sold. Where the just and reasonable rate has not yet been determined by the Commission, royalties are to be governed by the producers' effective rates, subject to

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[5] Commissioners Carver and O'Connor dissented from the basic jurisdictional holding, but expressed the view that royalties under one of the leases in issue were within the Commission's jurisdiction since the gas covered by the lease was committed to the interstate market at the time the lease was executed (Mobil App. 60–80).

adjustment upon establishment of the just and reasonable rate.[9]

On petitions for review, the court of appeals (Mobil App. 15–40) reversed the Commission's order. The court rejected the conclusion that, because a royalty owner retains an economic interest in the gas sold in interstate commerce, he is a participant in a subsequent sale of natural gas in interstate commerce and thus is a "natural gas company" within the meaning of Section 2(6) of the Natural Gas Act, 15 U.S.C. 717a(6).

REASONS FOR GRANTING THE WRIT

The issue in this case is of fundamental importance to the administration of the Natural Gas Act, 15 U.S.C. 717, *et seq.* The decision below that royalty payments on natural gas sold for resale in interstate commerce are not subject to the Commission's jurisdiction conflicts in principle with prior decisions of this Court. Unless overturned, the decision will significantly inhibit the Commission from effectively regulating the rates at which such gas is sold.

1. Under Section 1(b) of the Natural Gas Act, 15 U.S.C. 717(b), the provisions of the Act apply to "the sale in interstate commerce of natural gas for

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[9] Subsequent to the Commission's opinion, the Commission, in Opinion No. 586, the *Hugoton-Anadarko Area Rate Proceeding*, 44 FPC 761, appeal pending *sub nom. Hugoton-Anadarko Area Rate Case (People of the State of California and the Public Utilities Commission of the State of California* v. *Federal Power Commission*), C.A. 9, No. 71-1036, determined the just and reasonable rates for sales of natural gas in the area in which all of the leases involved in the present case are located.

resale." In *United Gas Improvement Co.* v. *Continental Oil Co.* (the "*Rayne Field*" case), 381 U.S. 392, 400, this Court held that whether a given transaction constitutes a "sale" within the scope of Section 1(b) turns, not on technical concepts of local law,[10] but on the economic effect of the transaction judged in the light of the purposes of the Natural Gas Act. The economic effect of royalty provisions in mineral leases is to give royalty owners a continuing economic interest in subsequent sales of natural gas and thus to make such owners participants in the sales.

In concluding that a royalty owner is not a participant in a sale of natural gas, the court below found determinative the fact that under a standard mineral lease a royalty owner has no control over the incidents of such a sale (Mobil App. 29). But that fact does not diminish the continuing economic interest of the royalty owner in the sale. It is the economic realities and physical facts, rather than concepts of local law or contractual provisions, which are controlling for determining the applicability of the Natural Gas Act. See *Rayne Field, supra*; *California* v. *Lo-Vaca Gathering Co.*, 379 U.S. 366.

In entering into an oil and gas lease, a royalty owner, in effect, appoints the lessee-producer as its agent. Under the lease, the producer is obligated to develop the leasehold and market any gas produced therefrom (Mobil App. 39, 92). If the royalty owner

[10] One basis of the court of appeals' reversal of the Commission's order in the present case was that the "royalty owner is not considered, * * * in conceptions of state law decisions, to be engaged in any 'sale' of gas" (footnote omitted) (Mobil App. 24).

had not entered into the lease, but had itself developed and sold in interstate commerce the natural gas underlying its property, it would clearly be subject to the Commission's jurisdiction.[11] The fact that the royalty owner designates another to develop and market the gas should not operate to bar Commission jurisdiction over the retained fractional interest of the royalty owner in the sale of the gas.

While it may be true, as the court below pointed out (Mobil App. 24), that a royalty owner has no title to the gas in which it has an interest, the absence of title under local law is not determinative. See *Rayne Field, supra*, 381 U.S. at 400. The transcending economic fact here is that the royalty owner has an interest in the production of gas which is sold for resale in interstate commerce. The only relevant difference from an economic viewpoint between the royalty owner's interest and the lessee-producer's interest is that the producer alone must bear the expenses incurred in discovering, producing and marketing the natural gas.

Finally, the fact that a royalty owner does not know at the time it enters into a mineral lease whether any natural gas produced will be sold in interstate, as opposed to intrastate, commerce is irrelevant to ultimate Commission jurisdiction. The actual disposition of the gas at the time of delivery is controlling for jurisdictional purposes, not the

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[11] The court below (Mobil App. 24, n. 10) noted that in the case of a royalty owner who took a share of the gas produced as royalty and sold it, its decision might be different.

knowledge or intention of the interest owners involved in the sale. Cf. *Shell Oil Co.* v. *Federa Power Commission*, 247 F. 2d 900 (C.A. 5), certiorari denied, 355 U.S. 930; *California* v. *Lo-Vaca Gathering Co.*, *supra*.

2. When Congress passed the Natural Gas Act, it "did not desire that an important aspect of this field be left unregulated," but intended instead to establish a comprehensive regulatory scheme. *Federal Power Commission* v. *Transcontinental Gas Pipe Line Corp.*, 365 U.S. 1, 19. The Act "was so framed as to afford consumers a complete, permanent and effective bond of protection from excessive rates and charges." *Atlantic Refining Co.* v. *Public Service Commission of New York* (*CATCO*), 360 U.S. 378, 388.

In *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672, this Court ruled that the Commission has jurisdiction over the rates at which producers sell natural gas to pipelines for resale in interstate commerce. The Court recognized that the rates charged by producers "may have a direct and substantial effect on the price paid by ultimate consumers." 347 U.S. at 685. By its ruling, the Court strove to give the ultimate consumer the full and complete protection envisaged by Congress in enacting the Natural Gas Act. The decision below, by exempting the royalty owner's interest in such sales from Commission jurisdiction, threatens to remove a significant portion of the protection afforded consumers under the rationale of *Phillips*.

As the Fifth Circuit observed in *J. M. Huber Corp. v. Denman*, *supra*, 367 F. 2d at 116–117, provisions for royalties in mineral leases have a direct bearing on the establishment of area rates for interstate sales of natural gas by producers. In the *Permian Basin Area Rate Proceedings*, 34 FPC 159 (ultimately upheld in full by this Court, 390 U.S. 747), for example, the Commission acted on the assumption that royalties for interstate sales would be based on the ultimate area rate established. See 34 FPC at 192, 218. If royalty owners are now entitled to royalties based on the "market value" of natural gas as interpreted by state or federal courts or state regulatory authorities, the owners would in many instances receive compensation in excess of the royalty component allowed in the area rates determined by the Commission. The Commission would then be required either to let producers absorb the increased royalty obligations or to adjust area rates upward to accommodate the higher payments, thereby causing consumers to pay higher prices for natural gas. In short, the Commission's control over one significant component in the establishment of area rates would be lost.[12]

[12] The effect of the decision below is not significantly ameliorated by the fact that, in setting area rates, the Commission has authority to determine the reasonableness of costs incurred by producers even where such costs are not directly subject to Commission jurisdiction. In the absence of jurisdiction over

It is axiomatic that the Natural Gas Act, like other federal regulatory legislation, should be interpreted in furtherance of the Act's general purpose to protect consumers by effective regulation of natural gas wholesale rates. Cf. *Securities and Exchange Commission* v. *Ralston Purina Co.*, 346 U.S. 119; *United States* v. *Southwestern Cable Co.*, 392 U.S. 157; *United States* v. *Bacto-Unidisk*, 394 U.S. 784. The Commission, accordingly, concluded that a royalty owner's continuing economic interest in the sale of natural gas for resale to interstate pipelines makes him a participant in the sale and subjects his royalty interest to the Commission's jurisdiction under Section 1(b) of the Act, 15 U.S.C. 717(b). The contrary holding of the court below would significantly impair the Commission's ability to implement one of the Act's basic objectives, and therefore warrants review by this Court.

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royalty owners, royalty costs would be fixed prior to the incidence of federal control. Cf. *Jersey Central Power & Light Co.* v. *Federal Power Commission*, 319 U.S. 61, 71–72. The royalty payments would thus "become perpetuated in large part in fixed items of cost which must be covered by rates charged subsequent purchasers of the gas, including the ultimate consumer." *Interstate Natural Gas Co.* v. *Federal Power Commission*, 331 U.S. 682, 692–693.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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